Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-100086-02
PJSewell

date: May 13, 2002

to: [redacted] LMSB [redacted]
Team Manager

from: Area Counsel
(Natural Resources:Houston)

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subject: **Request for LMSB Division Counsel Assistance - Proper Treatment of Interest Expense related to Arbitration Award**

[redacted] Inc. & Subsidiaries
EIN: [redacted]

We have written this memorandum in response to your request for informal technical assistance dated November 6, 2001 regarding the proper treatment of interest expense for the foreign parent corporation who guaranteed an agreement for its U.S. subsidiary. Simultaneously with the issuance of this advice to you, we will be sending it to the National Office for a ten day review under the Non-Docketed Significant Advice program. Please wait until this review is completed before acting on this advice. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether the taxpayer's foreign parent should accrue and deduct interest expenses related to an arbitration award against the taxpayer which was guaranteed by the taxpayer's foreign parent?

CONCLUSION

No, interest is deductible only when incurred on a primary liability of an obligor and the taxpayer's foreign parent never

became primarily and directly liable for the arbitration award before it was paid.

FACTS

I have relied on the facts set out in this memorandum for my opinion in this case. If you believe that I should consider additional facts, you should notify me as this could change my opinion.

On [redacted] Corporation, a subsidiary of [redacted] Inc., and [redacted] Inc. (later known as [redacted] Inc. and referred to herein as "[redacted]") entered into a contract [the "Agreement"] under which an entity known as "[redacted]" was created. [redacted] was the [redacted] to the public and [redacted] was the [redacted] supplier of [redacted] equipment. The basic purpose of the Agreement was to produce a profit-generating business in which [redacted]'s [redacted] could be linked with [redacted] equipment to provide [redacted] to the public for a [redacted] price of the same [redacted]. The Agreement set forth an arrangement whereby [redacted] would provide, at no charge, updated equipment to [redacted] which was capable of interfacing with [redacted]'s [redacted]. [redacted] would pay [redacted] for the equipment according to a pre-determined schedule. The parties expected the [redacted] to enter into contracts with [redacted] which would confer on [redacted] (and thus [redacted]) exclusive rights to [redacted] for a specified time, at specified surcharges, in exchange for the equipment upgrade. The Agreement expressly provided that the parties' intention was to create a relationship of contracting parties with the rights and obligations expressly established and not a partnership or joint venture.

[redacted] was a subsidiary of [redacted] Inc. at the time of the Agreement. [redacted], a [redacted] entity, was the foreign parent of [redacted] Inc. [redacted] unconditionally guaranteed the full and timely performance by [redacted] of its obligations of payment and performance under the Agreement. [redacted] Corporation guaranteed the performance of [redacted].

The Agreement contained an arbitration clause requiring disputes arising between the parties to be submitted to a [redacted] member arbitration panel under the laws on [redacted] and the rules of the American Arbitration Association.

By [redacted], the banks of the taxpayer's foreign parent compelled it to develop a strategy to raise cash

by selling non-core business assets due to recurring financial difficulties. In the summer of [redacted], [redacted][1] emerged as a potential buyer for [redacted].

On [redacted], [redacted] entered into a joint venture with [redacted] to acquire [redacted]. At the closing, [redacted] transferred all of its assets to the joint venture except its Agreement with [redacted]. On [redacted], [redacted] acquired complete control over the joint venture.

Prior to the formation of the joint venture between [redacted] and [redacted], [redacted] began arranging for [redacted] contracts due to [redacted] inactivity. In late [redacted], [redacted] brought a $[redacted] arbitration claim against [redacted] for breach of the [redacted] Agreement. On [redacted], the arbitrators awarded [redacted] $[redacted] for material breach of the Agreement commencing in [redacted].

On [redacted], the arbitration award was confirmed by the courts in accordance with [redacted] law. While the taxpayer is an accrual-based taxpayer, it did not deduct the arbitration award expense in [redacted].[2] The taxpayer filed an amended [redacted] Form 1120 which included an entry for the arbitration expense on the books but not on the return. On its amended [redacted] return, the taxpayer accrued interest in the amount of $[redacted]. On its [redacted] Form 1120, the taxpayer accrued interest in the amount of $[redacted].

In [redacted], the taxpayer negotiated and paid a reduced award. Taxpayer paid the award in its role as party to the Agreement through its subsidiary. On its [redacted] Form 1120, the

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[1] [redacted] was itself in the [redacted] business and was acknowledged to be [redacted]'s [redacted] competitor.

[2] I.R.C. § 461(a) provides that the amount of any deduction allowed "shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." For accrual method taxpayers, a liability is incurred and generally taken into account "in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability." Treas. Reg. §1.461-1(a)(2). In the case of a liability arising out of a breach of contract or settlement of a dispute in which a breach of contract is alleged, economic performance occurs as payment is made to the person to which the liability is owed. Treas. Reg. § 1.461-4(g)(2).

taxpayer deducted $[redacted] for the arbitration award expense.

LEGAL DISCUSSION

I.R.C. § 163(a) allows a deduction for "interest paid or accrued within the taxable year on indebtedness." In order for interest to be deductible under I.R.C. § 163(a), the interest must be for the taxpayer's own indebtedness, not on the indebtedness of another. Nelson v. Commissioner, 281 F.2d 1, 5 (5th Cir. 1960); Rushing v. Commissioner, 58 T.C. 996, 1000 (1972); Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 675-76 (1945), aff'd, 153 F.2d 301 (3d Cir. 1946). Generally, interest is deductible only when incurred on a primary liability of an obligor. Rushing, 58 T.C. at 1000.

A person who makes payments based on a guarantee may deduct interest paid or accrued after the default of the primary obligor; guarantors may not deduct interest paid or accrued before default. See Stratmore v. Commissioner, 785 F.2d 419, 422 (3d Cir. 1986). Default is the point at which the guarantor becomes primarily and directly liable for the debt and the interest thereon. Id. at 423.

In this case, the taxpayer's foreign parent did not make interest payments nor was it required to make interest payments pursuant to any official proceedings or pursuant to judicially enforced creditor demands. The indebtedness giving rise to interest is that of the taxpayer as primary obligor. If the taxpayer defaults on the payment of the arbitration award, then the taxpayer's foreign parent would become primarily and directly liable for the debt and any interest thereon; only at default would the taxpayer's foreign parent be entitled to accrue interest.

If you have any questions on this matter, please call me at (303) 844-2214 ext. (b)(6).

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By: _____
PAMELA J. SEWELL
Attorney (LMSB)

cc: Tim A. Nelson, International Examiner